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C O N F I D E N T I A L SECTION 1 OF 2 MONTEVIDEO 3758

E.O. 11652: GDS
TAGS: EFIN, UY
SUBJ: REPORT ON IMF/IBRD CONSULTATIONS - URUGUAY

1. SUMMARY: A JOINT IMF/IBRD TEAM VISITED URUGUAY DECEMBER 2-19, AND REPORTED TO EMBASSY/AID OFFICERS THE FOOLOWING: (A) THAT THE ECONOMIC PERFORMANCE DETERIORATED IN 1974 AS A RESULT OF EXTERNAL FACTORS, WITH A BALANCE OF PAYMENTS OF DEFICIT PROJECTED OF DOL-100MILLION, A BUDGET DEFICIT OF ABOUT 31 PERCENT OF EXPENDITURES AND AN INFLATION RATE OF OVER 100 PERCENT; (B) THAT THE GOU ECONOMIC TEAM CONTINUES TO MANIFEST A POSITIVE DISPOSITION TO UNDERTAKE THE NECESSARY SELF-HELP MEASURES INVOLVING BASIC STRUCTURAL REFORMS TO DEAL WITH SITUATION DURING 1975; (C) THAT WHILE NEGOTIATIONS ON A IMF STANDBY ARE WELL ADVANCED, FUND CONDITIONS WERE TOUGH AND SOME KEY ISSUES REMAIN UNRESOLVED. FINAL AGREEMENT WILL ACCORDINGLY BE DELAYED UNTIL FEBRUARY (WHEN THE IMF TEAM WILL RETURN) TO GIVE THE GOU MORE TIME TO REFINE ITS ECONOMIC PROGRAM AND INCORPORATETHE BASIC ADJUSTMENTS ESSENTIAL FOR A STANDBY; (D) THAT ONCE THE STANDBY IS AUTHORIZED, THE IBRD WOULD CONSIDER MAKING SECTOR LOANS IN AGRICULTURE OR INDUSTRY, PLUS PROJECT LOANS TO PROVIDE ABOUT $50 MILLION ANNUAL ASSISTANCE LEVEL FOR THE NEXT TWO YEARS. THE IBRD WILL ALSO CARRY
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OUT DURING 1975 IN-DEPTH STUDIES OF THE AGRICULTURAL AND

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TRANSPORT SECTORS TO IDENTIFY AND PREPARE SUITABLE DEVELOPMENT PROJECTS FOR FUTURE BANK FINANCING. THE LONG-DELAYED SOFROLEC STUDY ON THE PROPOSED PALMAR DAM SHOWS A HIGHLY FAVORABLE INTERNAL RATE OF RETURN AND THE IBRD IS PREPARED TO CONSIDER FINANCING IT IT THE GOU ECONOMIC PERFORMANCE (UNDER A STANDBY) IS SATISFACTORY. END SUMMARY.

2. A JOINT IMF/IBRD CONSULTATION TEAM VISITED URUGUAY DECEMBER 2-19, HEADED BY JACK GUNTHER FOR THE IMF AND DAVID GREEN FOR IBRD. AFTER A PERIOD OF INTENSIVE WORK AND CONSULTATIONS, THE TEAM REPORTED TO EMBASSY/AID OFFICERS THE FOLLOWING RESULTS AND COMMENTS:

(A) OVERALL PERFORMANCE - 1974
(1) THE GOU ECONOMIC TEAM HAD THEIR HOMEWORK WELL PREPARED IN DIAGNOSING 1974 ECONOMIC PERFORMANCE BUT THE PROPOSED 1975 ECONOMIC PROGRAM WAS INCOMPLETE IN CERTAIN ASPECTS. WHILE NO GDP ESTIMATES ARE CURRENTLY AVAILABLE, THERE WAS A SIGNIFICANT IF EXPECTED DETERIORATION IN KEY INDICATORS AS A RESULT OF EXTERNAL FACTORS (OIL AND COMMODITY PRICES, CEE RESTRICTIONS ON MEAT IMPORTS, ETC.) AS WELL AS INTERNAL FACTORS(E.G., INADEQUATE FISCAL AND STABILIZATION MANAGEMENT). THE EFFECTS OF THE GENERAL DETERIORATION WERE SOMEWHAT CONTAINED BY A STRONG PERFORMANCE IN THE AGRICULTURAL SECTOR AND A SIGNIFICANT EXPANSION OF NON-TRADITIONAL EXPORTS (UP ABOUT 70 PERCENT OVER 1973).
(2) BALANCE OF PAYMENTS: THE 1974 DEFICIT IS PROJECTED AT AROUND $95-100 MILLION ON THE IMF'S OFFICIAL SETTLEMENTS BASIS. IT WOULD HAVE BEEN GREATER HAD NOT A YEAR-END IMPROVEMENT IN THE CAPITAL ACCOUNT HELPED STEM THE SHARP SHIFT IN THE CURRENT ACCOUNT (FROM PLUS $37 MILLION IN 1973 TO MINUS $195 MILLION IN 1974) WITH THE CENTRAL BANK LOSING ABOUT $90-100 MILLION IN RESERVES. THE CAPITAL INFLOW OF THE PAST TWO MONTHS REFLECTS, INTER-ALIA, ARGENTINE FLIGHT CAPITAL, ACTIVE SALES OF NEW SERIES OF DOLLAR TREASURY BONDS, PROCEEDS FROM THE IMF OIL FACILITY ($55 MILLION), RECENT SOUTH AFRICAN RESERVE BANK DEPOSITS AND TREASURY BOND PURCHASES
TOTALLING $40 MILLION AND PRIVATE BANK CREDITS. (WE HEAR THAT FNCB (NY) PLANS TO ROLL OVER ITS $50 MILLION CREDIT EXTENDED IN 1974 AND TO
PURCHASE $10 MILLION OF TREASURY BONDS.) BALANCE OF PAYMENTS
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PROSPECTS FOR 1975 DEPEND PRIMARILY ON WORLD MARKET CONDITIONS FOR BEEF AND WOOL AND CURRENT PROJECTIONS REMAIN GLOOMY. THE IMF, CONCERNED ABOUT THE SIZE OF THE 1974 AND PROSPECTIVE 1975 DEFICITS AND THE RAPID EXPANSION IN GOU EXTERNAL DEBT, PROPOSES SETTING RESTRICTIVE BALANCE OF PAYMENTS TARGETS, THE EFFECTS OF WHICH WOULD BE TO LIMIT IMPORTS AND EXTERNAL BORROWING. THIS REMAINS A KEY ISSUE TO BE RESOLVED IN STANDBY NEGOTIATIONS.

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(3) INFLATION: THE CPI INFLATION RATE WILL BE ABOUT 100 PERCENT IN 1974, UP 21 PERCENT FROM 1973, AND 30 PERCENT ABOVE GOU PROJECTIONS. PRINCIPAL CAUSES ARE THE CHRONIC WAGE-PRICE SPIRAL PRICE RISE RESULTING FROM DECONTROL ACTIONS IN A NUMBER OF CONSUMER ITEMS INCLUDING RENTS, THE GOU'S CONTINUING FISCAL DEFICIT, EXCESSIVE CREDIT EXPANSION BY THE BANK OF THE REPUBLIC (BOR) AND IMPORTED INFLATION (AN 80 PERCENT INCREASE IN AVERAGE IMPORT PRICES IN 1974). THE TEAM CONSIDERS THE DESIGN OF A VIABLE STABILIZATION PLAN A CRUCIAL ELEMENT OF AN ACCEPTABLE ECONOMIC PROGRAM AND A STANDBY AGREEMENT AND HOPES THAT THE ADOPTION OF SUCH A PLAN COULD REDUCE INFLATION TO ABOUT 75 PERCENT IN 1975. THEY HAVE DISCUSSED ALTERNATIVE STRATEGIES TO THIS END WITH GOU AUTHORITIES. WE HAVE RELIABLE INFORMATION THAT MINISTER OF ECONOMY VEGH VILLEGAS IS DISATISFIED WITH THE "GRADUALIST"APPROACH TO STABILIZATION FOLLOWED SO FAR AND IS ACTIVELY CONSIDERING A "SHOCK" APPROACH INCLUDING A GENERAL WAGE AND PRICES FREEZE TO BE INTRODUCED IN JANUARY. THE GOU ECONOMIC TEAM AND THE IMF TEAM AGREE THAT THE HERETOFORE UNCONTROLLED CREDIT EXPANSION BY THE BOR, UTILIZING REDISCOUNT FACILITIES WITH THE CENTRAL BANK (CB), HAS BEEN A KEY FACTOR IN 1974 INFLATION. THEY BOTH CONSIDER A STRICT CREDIT PROGRAM, TO WHICH THE BOR IS BOUND, TO BE A SINE QUA NON TO AN EFFECTIVE STABILIZATION PROGRAM. THE GOU APPEARS ON THE WAY TOWARD CONTROLLING THE BOR IN THIS REGARD. THE PRESIDENCY OF THE CENTRAL BANK PASSED ON DECEMBER 24 TO JOSE GIL, FORMERLY SUB-SECRETARY UNDER VEGH, AND WE HEAR THAT A SECOND CB DIRECTOR AND VEGH SUPPORTER IS SOON TO BE NAMED, WHICH WILL GIVE THE MINISTER EFFECTIVE CONTROL OF THE THREE-MEMBER CB BOARD AND INDIRECT CONTROL OVER THE BOR (THROUGH RESTRICTING THE USE OF THE REDISCOUNT FACILITY). THUS, FOR THE FIRST TIME IN YEARS, THE MINISTER OF ECONOMY WILL HAVE INCREASED CONTROL OVER THE KEY INSTRUMENTS OF MONETARY AND CREDIT POLICY ESSENTIAL TO CARRYING OUT A COHERENT STABILIZATION PROGRAM. WHILE THE BOR, LED BY ITS VP GENERAL RAYMUNDEZ, IS STRONGLY RESISTING THESE CHANGES, THE FACT THAT VEGH IS ABLE TO GAIN

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CONTROL OF THE CENTRAL BANK INDICATES HE CONTINUES TO HAVE THE POLITICAL SUPPORT FOR REFORM.

(4) FISCAL SITUATION: THE TEAM FOUND DETERIORATION IN THE 1974 FISCAL SITUATION (31 PERCENT DEFICIT IN RELATION TO EXPENDITURES) TO BE MORE SERIOUS THAN EARLIER EXPECGED. THE BASIC CAUSES ARE INCREASED GOU PERSONNEL COSTS REFLECTING PERIODIC GENERAL WAGE

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AND SALARY ADJUSTMENTS, GOVERNMENT SUBSIDIES FOR CONSUMER ITEMS (WHEAT, VEGETABLE OIL, SUGAR, ETC) SERIOUSLY LAGGING TAX COLLECTIONS, AND REDUCTION OR ELIMINATION OF CERTAIN TAXES (EG, EXPORT TAXES) WITHOUT COMPENSATING INCREASES IN OTHER REVENUES. THE GOU WAGE BILL WAS ADVERSELY AFFECTED IN 1974 BY A SPECIAL AND UNANNOUNCED 40 PERCENT INCREASE IN MILITARY PAY SCALES IN SEPTEMBER ABOVE AND BEYOND THE PERIODIC WAGE ADJUSTMENTS FOR PUBLIC SECTOR EMPLOYEES, INCLUDING THE MILITARY. VEGH, HAVING INHERITED A DETERIORATING FISCAL SITUATION ON TAKING OFFICE IN JULY, SHARES THE IMF CONCERNS IN THIS AREA, AND APPEARS DISPOSED TO TAKE THE NECESSARY STABILIZATION AND BUDGETARY MEASURES. DURING THE LAST MONTHS OF 1974, VEGH TOOK THE FIRST STEPS TO CONTAIN FISCAL HEMORRHAGING BY SHARPLY REDUCING OR ELIMINATING SUBSIDIES ON A NUMBER OF ITEMS. THERE IS A CONCENSUS AMONG THE IMF/IBRD AND THE GOU ECONOMIC TEAM THAT THE KEY TO THE FISCAL PROBLEM IS A BASIC REFORM OF THE TAX SYSTEM. IN THIS REGARD, ACTION WAS TAKEN DURING 1974 TO ELIMINATE LOW YIELD, HIGH COST NUISANCE TAXES, REDUCE SIGNIFICANTLY EXPORT TAXES, AND TO RE-ORIENT THE TAX SYSTEM TOWARD CONCENTRATION ON THE LAND PRODUCTIVITY TAX (IMPROME) AND THE VALUE-ADDED TAX, AN ORIENTATION RECOMMENDED BY SEVERAL INTERNATIONAL EXPERTS INCLUDING AID CONSULTANT, DR. ARNOLD HARBERGER. 1974 REVENUE COLLECTIONS HAVE LAGGED BEHIND IN-FLATION IN REAL TERMS - PARTIALLY DUE TO THE ECONOMIC DIFFICULTIES IN
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LIVESTOCK INDUSTRY ADVERSELY AFFECTING IMPROME COLLECTIONS,

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BUT PRIMARILY THE RESULT OF CRITICAL WEAKNESSES IN TAX ADMINISTRATION GENERALLY. WHILE MINISTER VEGH IS CONCERNED ABOUT THE PROBLEM OF TAX ADMINISTRATION, HIS INABILITY SO FAR TO RECRUIT A COMPETENT DIRECTOR GENERAL OF TAXES HAS DELAYED IMPLEMENTATION OF A REORGANIZATION PLAN WORKED OUT WITH THE ASSISTANCE OF AID/IRS ADVISORS. WE CONTINUE TO HEAR THAT THE APPOINTMENT OF A NEW DIRECTOR IS IMMINENT. ALSO, THE FISCAL TARGETS PROPOSED FOR AN IMF STANDBY WILL CERTAINLY HAVE THE EFFECT OF ACCELERATING A DRASTIC SHAKE-UP OF THE TAX SYSTEM AND ADDITIONAL POLICY MEASURES TO REMOVE CERTAIN DISINCENTIVES TO TAXPAYER COMPLIANCE (E.G., TEN PERCENT DISCOUNT FOR TAX PAYMENTS ON TIME.

(5) EXCHANGE RATES. THE IMF TEAM APPEARED PLEASED WITH THE RESULTS OF RECENT GOU REFORMS TO LIBERALIZE THE FINANCIAL FX MARKET AND PERMIT FREE PESO CONVERTIBILITY. SINCE LATE NOVEMBER, THE FINANCIAL RATE HAS FLOATED BETWEEN 2100-2400 PESOS PER US DOLLAR WITH NO EVIDENCE OF GOU INTERFERENCE OR BLACK MARKET OPERATIONS, ALTHOUGH THERE IS SOME INFORMAL RATIONING OF FOREIGN CURRENCY BY THE BANKS THEMSELVES. VEGH'S GAMBLE IN LIBERALIZING THE FINANCIAL RATE HAS WORKED OUT MUCH AS HE PREDICTED, AND HAS INCREASED HIS SUPPORT IN THE PRIVATE SECTOR AND AMONG THE MILITARY. THE IMF STILL CONSIDERES THE COMMERCIAL RATE, NOW ABOUT 1580 PER DOLLAR, TO BE OVERVALUED ABOUT 20-25 PERCENT. VEGH'S STATED POLICY IS TO UNIFY THE TWO RATES AT SOME POINT BUT THERE IS NO INDICATION WHEN THIS WILL OCCUR.

3. IMF ASSESSMENT AND PLANS.

GUNTHER CONSIDERS THAT POSITIVE GOU ATTITUDES AND PROGRESS MADE DURING RECENT NEGOTIATIONS AUGUR WELL FOR SUCCESSFUL CONCLUSION OF A STANDBY IN FEBRUARY. HE INDICATED THAT IN SEVERAL KEY AREAS, STABILIZATION AND FISCAL POLICY PARTICULARLY, THE GOU HAS TO RETHINK ITS POSITION AND REFINE AN ECONOMIC PROGRAM THAT MEETS MINIMUM IMF CONDITIONS. HE APPEARED CONFIDDNT THAT THIS COULD BE DONE. THE STANDBY WOULD BE FOR A FIRST TRANCHE CREDIT OF $20 MILLION WITH QUALITATIVE PERFORMANCE TARGETS. QUANTITATIVE CRITERIA AND CEILINGS WOULD GOVERN ANY SECOND TRANCHE AGREEMENT IF GOU PERFORMANCE SO MERITED. HE EXPECTS THE STANDBY WOULD BE PROBABLY AUTHORIZED BY THE IMF BOARD IN EARLY MARCH. THE GOU WOULD SOON BE ABLE TO DRAW ANOTHER $5 MILLION FROM THE IMF OIL
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FACILITY BRINGING ITS TOTAL IN 1974 TO $60 MILLION. WHETHER THE GOU WILL BENEFIT FROM THE OIL FACILITY IN 1975 DEPENDS ON THE FUTURE OF THIS FACILITY. GUNTHER WAS DOUBTFUL WHETHER URUGUAY WOULD BE ELIGIBLE DURING 1975 FOR THE NEW IMF EXTENDED CREDIT FACILITY, ALTHOUGH THE GOU HAS OFFICIALLY REQUESTED IT. IF GOU PERFORMANCE ON A STANDBY PROGRAM IS GOOD, URUGUAY COULD WELL BENEFIT FROM THIS FACILITY IN 1976.

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4. IBRD ASSESSMENT AND PLANS.

GREEN CONSIDERS SITUATION IN URUGUAY IS SUCH THAT, ASSUMING AN IMF STANDBY, IBRD WOULD BE PREPARED TO CONSIDER EXPANDED ASSISTANCE OVER COMING YEARS. HE SAID THAT, WHILE THE BANK STAFF ORIGINALLY CONTEMPLATED A PROGRAM LOAN AS THE PREFERRED FORM OF ASSISTANCE, RECENT SOUNDINGS AT THE BOARD LEVEL WERE NOT FAVORABLE, SO THE STAFF IS NOW CONSIDERING MAKING SECTOR LOANS IN INDUSTRY AND AGRICULTURE OVER NEXT TWO YEARS. TOGETHER WITH THE PLANNED ANNUAL LIVESTOCK LOANS, THESE COULD RESULT IN OVERALL ANNUAL IBRD ASSISTANCE PACKAGES OF AROUND $50 MILLION. LOANS WOULD MOST LIKELY BE FOR COMMODITY IMPORTS OF INDUSTRIAL OR AGRICULTURAL GOODS WITH PESO COUNTERPART GOING FOR SECTORAL INVESTMENT PROGRAMS. IT IS LIKELY THAT THE IBRD WILL CONDITION ITS SECTOR LOANS NOT ONLY ON THE IMF STANDBY BUT ON CERTAIN ADDITIONAL SELF-HELP MEASURES SUCH AS IMPORT LIBERALIZATION, ESTABLISHMENT OF A DEVELOPMENT BANK, ETC. AN IBRD MISSION, HEADED BY MR. FAVILLA, IS EXPECTED IN JANUARY TO CONSULT WITH GOU TO DETERMINE FORM AND MAGNITUDE OF THE PROPOSED ASSISTANCE PACKAGE. WE ALSO ARE ADVISED THAT THE UNDP HAS AGREED TO FINANCE TWO IBRD SECTORAL ASSESSMENTS IN AGRICULTURE AND TRANSPORTATION, THE PURPOSE OF WHICH IS TO IDENTIFY AND PREPARE AN INVENTORY OF PRIORITY DEVELOPMENT PROJECTS WHICH THE BANK COULD FINANCE IN THE FUTURE. FINALLY, THE LONG DELAYED SOFROLEC STUDY ON THE ENERGY SECTOR HAS BEEN COMPLETED AND REPORTEDLY SHOWS A VERY POSITIVE INTERNAL RATE OF RETURN FOR THE PROPOSED PALMAR DAM, WHICH THE WORLD BANK NOW APPEARS READY TO FINANCE ASSUMING ACCEPTABLE GOU ECONOMIC PERFORMANCE UNDER THE STANDBY.

5. COMMENT. THE DIRECTOR OF PLANNING (OPP) HAS CONFIDENTIALLY ADVISED THE AID REP THAT WHILE IMF CONDITIONS FOR A STANDBY WERE MUCH HARSHER THAN EXPECTED, HE WAS CONFIDENT THAT AN AGREEMENT WOULD BE REACHED BY MARCH. THERE IS CONCERN IN OPP THAT THE CONFIDENTIAL

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DEGREE OF IMPORT RESTRAINT AND LIMITATION ON DEBT EXPANSION PROPOSED BY IMF COULD LEAD TO A DOMESTIC RECESSION AND INCREASED UNEMPLOYMENT. LIKEWISE, CONCERNED ABOUT THE FISCAL DEFICIT, THE IMF TEAM SUGGESTED REIMPOSING OR INCREASING EXPORT TAXES ON WOOL AND MEAT, A MOVE OPP CONSIDERS CONTRARY TO ITS BASIC AGRICULTURAL POLICY. IN GENERAL, HE PREDICTED THE GOU COULD WORK OUT WITH THE IMF ENSATISFACTORY FISCAL PROGRAM. IN RESPECT TO STABILIZATION POLICY, HE INDICATED THAT VEGH WAS REVISING HIS STRATEGY AND NOW IS CONSIDERING A "SHOCK" APPROACH.

6. IT APPEARS THAT WHILE THE IMF STANDBY CONDITIONS WERE TOUGH, WHICH HAS SENT THE GOU ECONOMIC TEAM BACK TO THE DRAWING BOARDS TO REFINE ITS PROGRAM, THERE ALSO SEEMS TO BE A CLEAR CONCENSUS THAT A STANDBY IS ESSENTIAL TO BOTH SHORT TERM ECONOMIC SURVIVAL AND LONGER TERM DEVELOPMENT AND THAT NEGOTIATIONS CANNOT BE PE-

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MITTED TO FAIL. VEGH APPEARS PREPARED TO DEFINE AN ECONOMIC PROGRAM WHICH REASONABLY ACCOMODATES IMF CRITERIA. BECAUSE A STANDBY WILL IMPLY A TOUGH AUSTERITY PROGRAM AFFECTING LEVELS OF ECONOMIC ACTIVITY, REAL INCOMES AND EMPLOYMENT, IT WILL POSE CRITICAL POLITICAL DECISIONS FOR THE GOU. WHETHER VEGH CAN DEVELOP THE NECESSARY POLITICAL/MILITARY SUPPORT FOR SUCH A PROGRAM REMAINS TO BE SEEN. OPPOSITION IS LIKELY TO ARISE WITHIN THE GOU, PRIMARILY IN THE BOR, AND AMONG SOME MILITARY ELEMENTS (GEN. RAYMUNDEZ) AND PERHAPS AMONG PRIVATE SECTOR GROUPS WHO WOULD BE ADVERSELY AFFECTED. WE ESTIMATE THE CHANCES ARE GOOD THAT AFTER A VIGOROUS INTERNAL DEBATE, VEGH'S PROGRAM AND THE IMF STANDBY WILL BE APPROVED BY THE GOU. THE BASIC REASONS FOR THIS JUDGEMENT ARE (A) THE OPPONENTS OF VEGH HAVE NO VIABLE ALTERNATIVE PROGRAM TO DEAL WITH THE ECONOMIC SITUATION; (B) VEGH APPEARS TO HAVE BROAD SUPPORT IN THE PRIVATE SECTOR AND AMONG MOST OF THE SENIOR CIVILIAN AND MILITARY LEADERS; AND (C) THE VEGH PROGRAM PROMISES BOTH SUBSTANTIAL EXTERNAL ASSISTANCE FOR SHORT-TERM FINANCIAL CRISIS MANAGEMENT AS WELL AS FOR LONG-TERM DEVELOPMENT (AGRICULTURE, INDUSTRY AND PALMAR). IT ALSO MAY BE A KEY TO OBTAINING INCREASED PRIVATE FOREIGN COMMERCIAL LOANS. NOW THAT THERE IS NEW ECONOMIC LEADERSHIP, A DEFINED PROGRAM AND GOOD PROSPECTS FOR INTERNATIONAL FINANCIAL SUPPORT, THERE ARE PROBABLY FEW AMONG THE POWER BROKERS IN THE GOU, CIVILIAN OR MILITARY, WHO WOULD WELCOME VEGH'S DEPARTURE WHICH COULD FOLLOW A FAILURE TO GET APPROVAL FOR HIS PROGRAM. A SIDE FROM HIS IMPRESSIVE PROFESSIONAL CAPACITIES, THIS FACTOR CONSTITUTES PERHAPS THE MOST
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IMPORTANT SINGLE ADVANTAGE VEGH WILL HAVE IN GAINING SUPPORT FOR HIS PROGRAM.

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